

Emerging perspectives on the evolving arm's length principle and formulary apportionment

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Abstract

A decade ago, the arm's length principle on which transfer pricing rules and practices are based, was entrenched, and suggestions for change minimal and largely dismissed by practitioners. In this article we discuss more recent calls for a change in approach, many of which focus on some form of formulary apportionment. While there is an increasing body of academic literature on formulary apportionment, it is much less referred to in the practitioner literature and has received less focus in the context of tax practitioners. We present evidence from a longitudinal study, of a change in attitude among senior transfer pricing professionals, from strong support for arm's length pricing coupled with a dismissal of formulary apportionment, towards greater willingness to raise the limitations of arm's length pricing, coupled with a muted acceptance, and application, of some formulary approaches.

Introduction

Established transfer pricing practices rest on two widely accepted fundamental principles; firstly, separate treatment of parts of a multinational enterprise (MNE) that have a presence in separate tax jurisdictions (separate accounting) and secondly, the arm's length principle (ALP). Notwithstanding that the ALP is insufficiently underpinned by a coherent theory¹, the principle, based on what unrelated third parties would do, remains the cornerstone of tax transfer pricing in most countries. However, increasingly, attention is being paid to its short-comings. While there are differing views on how to address these, there has been an increase in calls for a change to formulary apportionment, the allocation of the profits of an MNE to each taxing jurisdiction according to a predetermined formula.² There is a growing body of academic literature on formulary apportionment, and other alternatives to the ALP, including destination-based cash flow tax³ and speculatively, a residence based formulary apportionment system⁴. However, among those calling for a change to a formulary approach it has been observed that senior officials and practitioners have “strenuously opposed replacing current transfer pricing rules with a formulary system, and there is no indication that this opposition is weakening.”⁵

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¹ S.C. Morse, “Seeking Comparables in Patents and Tax” (2019) *Revenue Litigation Brief* 37.

² Evidence of a shift in attitude in favour of formulary apportionment is limited, although occasionally it is referred to as a given, but unsubstantiated. For example, Self reports that the UK All-Party Parliamentary Group on Responsible Tax report that in a seminar held by the APPG with academics and other stakeholders there was broad support for formula apportionment overseen by a global body; although there was no apparent explanatory support for this. H. Self “Report of the all-party parliamentary group on responsible tax on the OECD's Base Erosion and Profit-shifting project” [2016] BTR 407.

³ A. Auerbach, M.P. Devereux, M. Keen and J. Vella, Destination-based cash flow taxation, Said Business School Research Paper (2017).

⁴ W. Cui, “Residence-based formulary apportionment: (In)feasibility and Implications”, (2018) *Tax Law Review* 551.

⁵ M. Durst, “A practical approach to a transition to formulary apportionment” in S. Picciotto (ed) *Taxing Multinational Enterprises as Unitary Firms*, (Brighton: Institute of Development Studies, 2017) 49.

This article contributes to this ongoing debate, firstly by reviewing and considering some of the theoretical arguments for, and concerns about, formulary apportionment. Then, within the context of that debate, we present and discuss qualitative data from 34 interviews with international tax practitioners working at the most senior level in respect of transfer pricing in the UK and the US. The interviews took place in 2006 and 2016/17, with overlapping interviewees, allowing us to isolate changes in attitude over a period of time in which there was a change in the profile of transfer pricing: it moved from being seen as a technical specialism of interest to some tax practitioners, to an area of much wider interest, subject to increasing media scrutiny. Specifically, our longitudinal data shows that there has been a weakening of confidence in, and increased frustration with, the ALP among senior transfer pricing professionals, and a loosening in the strenuous opposition to formulary apportionment.

The next section discusses the transfer pricing environment, drawing on literature that charts the development of the evolving ALP. Much of this highlights the importance of the role of international consensus on the ALP, and how the strength of this consensus has fluctuated over time. This provides context to underpin the subsequent discussion of the large body of literature on calls for reform and a move to formulary apportionment. It also provides context for the interviews carried out in 2006 and 2016/17. We then discuss the evolving attitudes of senior transfer pricing practitioners to these issues. The changing challenges that we raise and discuss suggest areas for attention and future research.

Background and related literature

Transfer pricing background

The ALP, based on the benchmark of what an independent enterprise would do, dates back to the 1930s⁶ and the vagueness of the principle has allowed it to evolve and be reinterpreted over time. The OECD has been one of the most important influences in building consensus for the ALP, diffusing it through its guidelines and model convention⁷. In 1992 it appeared that international consensus on arm's length transfer pricing, based on "the legal fiction of the separate entity approach"⁸ was under threat, jeopardized by the US issuing new transfer pricing regulations, with a move away from basing the ALP on comparable transactions, to looking at comparable profits. In response, an OECD Task Group worked with the US Treasury to amend the US regulations and to reissue the OECD Guidelines⁹. A major effort of the OECD was to build consensus and avoid the US defecting from international cooperation built around the ALP.¹⁰

In 1995 the OECD Transfer Pricing Guidelines for multinational enterprises and tax administrations were reissued (OECD 1995 Guidelines) and the chapter on the ALP "reaffirm[ed] its status as the international standard."¹¹ The OECD 1995 Guidelines set out five acceptable pricing methods; the preferred method being the use of a comparable uncontrolled price, requiring the identification of an identical, or very similar, transaction between unrelated parties, although in practice, with a small handful of exceptions, there will not be a directly comparable price¹². The profit split approach was

⁶ S. Picciotto, "International taxation and intrafirm pricing in transnational corporate groups" (1992) *Accounting Organizations and Society* 759.

⁷ C.Radaelli. "Game theory and institutional entrepreneurship: transfer pricing and the search for coordination in international tax policy" (1998) *Policy Studies Journal* 603.

⁸ E. Baistrocchi, "The transfer pricing problem: a global proposal for simplification" (2006) *Tax Lawyer* 4.

⁹ L. Eden, T. Dacin and W. Wan, "Standards across borders: crossborder diffusion of the arm's length standard in North America" (2001) *Accounting Organizations and Society* 1.

¹⁰ Radaelli above fn 7.

¹¹ Transfer pricing guidelines for multinational enterprises and tax administrations. Report of the OECD Committee on Fiscal Affairs, Paris: OECD Publishing, 1995 at I-1.

¹² See for example M.C.Durst and R.E. Culbertson, "Clearing away the sand: retrospective methods and prospective documentation in transfer pricing today"(2003) *Tax Law Review* 39; J. Grocott, "Battered and bruised but still standing" (2009) *International Tax Review* 12; A. Vega "International governance through soft

listed at this time as the method of “last resort”¹³: Some countries objected to the inclusion of the profit split method as it did not rely on comparables¹⁴. This inclusion was largely done by framing the ALP in broad terms: the OECD guidelines and US regulation were generally consistent in approach, but with differences in emphasis. Therefore “an apparent consensus was maintained, by the insistence that all these methods comply with the arm’s length principle.”¹⁵ Following publication of the 1995 OECD Guidelines there was a “torrent”¹⁶ of different, often inconsistent national rules, falling within the broad ambit of the ALP. A 2006 survey reported “a significant shift towards broader acceptance of the [ALP] on a basis consistent with the OECD Guidelines”¹⁷ albeit with a degree of divergence in approach between countries.

In addition to the maintenance of international consensus, the ambiguity of the ALP also offers the advantage of flexibility to cover very different transactions and situations. However, the disadvantage of such flexibility is the consequent lack of certainty as to whether transfer prices will be acceptable to the relevant tax authorities. This is, of course, problematic within large, highly integrated MNEs, where there are interdependencies and transactions that would not arise in an arm’s length situation and particularly when there are intangibles.¹⁸ Determining appropriate transfer prices became a fact intensive and context-specific process, requiring the maintenance of large amounts of documentation, including functional analysis and risk analysis, and economic analysis of databases as evidence to justify the prices used, with varying documentation requirements in different countries. The subjectivity in applying the ALP created scope for disagreement between taxpayers and tax authorities, but also between different tax authorities and indeed, different views between those in the same tax authority or same advisory firm or in-house tax department. The prospect of disputes, double taxation, tax penalties as well as negative publicity began to increase at this time. Disputes between taxpayers and tax authorities, or between different tax authorities, were protracted under the Mutual Agreement Procedure (MAP) and there was no obligation on tax authorities to reach agreement. The Advance Pricing Agreement (APA) mechanism, used to obtain tax authority agreement was seen as costly and time consuming.¹⁹ Although MNE applications to use this procedure vary by industry sector, only a small number of MNEs proceeded with an APA; typically a lower number than the Mutual Agreement Procedure (MAP), and historically the majority of MAP cases relate to transfer pricing.²⁰

law: the case of the OECD transfer pricing guidelines” (2012) Working paper 2012-05 July 2012 Max Planck Institute for Tax Law and Public Finance.

¹³ OECD 1995 Guidelines above fn 5 at 3.5. The hierarchy of methods persisted until the 2010 revision.

¹⁴ R.S. Avid-Yonah and Z. Pouga Tinhaga “Formulary apportionment and international tax rules” in S.Picciotto (ed) *Taxing Multinational Enterprises as Unitary Firms*, (Brighton: Institute of Development Studies, 2017).

¹⁵ S. Picciotto, “Indeterminacy, complexity technocracy and the reform of international corporate taxation” (2015) *Social and Legal Studies* 165 179.

¹⁶ J.M. Calderon, “European transfer pricing trends at the crossroads: Caught between globalization, tax competition and EC law” (2005) *Intertax* 103.

¹⁷ Ernst & Young 2005-2006 Global Transfer Pricing Surveys, available at https://www.ub.unibas.ch/digi/a125/sachdok/2012/BAU_1_5682903_2005_2006.pdf

¹⁸ M.A. Kane “Transfer pricing, integration and synergy intangibles: a consensus approach to the arm’s length standard” (2014) *World Tax Journal* 290.

¹⁹ D. Ring “On the Frontier of procedural innovation: advance pricing agreements and the struggle to allocate income for cross border taxation” (2000) *Michigan Journal of International Law* 143.

²⁰ H. Rogers and L. Oats “The use of Advance Pricing Agreements in transfer pricing management” [2013] BTR 76. APAs are becoming more prevalent, for example a 2017 survey by Ernst & Young reports that some 38% of respondents have used APAs of one form or another to increased certainty and prevent controversy, see [https://www.ey.com/Publication/vwLUAssets/ey-transfer-pricing-controversy-avoidance-and-resolution/\\$FILE/ey-transfer-pricing-controversy-avoidance-and-resolution.pdf](https://www.ey.com/Publication/vwLUAssets/ey-transfer-pricing-controversy-avoidance-and-resolution/$FILE/ey-transfer-pricing-controversy-avoidance-and-resolution.pdf). Ryding records a sharp increase in APAs across the European Union from 399 at the end of 2013 to 2,1053 at the end of 2016, Tax Sweetheart Deals between multinationals and EU countries at record high, Eurodad, available at <https://eurodad.org/files/pdf/1546881-tax-sweetheart-deals-between-multinationals-and-eu-countries-at-record-high.pdf>

The 2010 revised OECD Transfer Pricing Guidelines reiterated “support for the consensus on the use of the arm's length principle.”²¹ Although much was unaltered, changes included: profit split methods no longer being described as the method of last resort, a new chapter on business restructuring and new guidance on comparability. This was against a backdrop of the continued rise in integrated MNEs, an increasingly complex system to try to address this²² and increased e commerce and digitalization.²³ Following the financial crisis there was rising media attention and scrutiny of high-profile cases of corporate tax avoidance in both the US²⁴ and the UK, including for example, publicity of Starbucks' low corporation tax payments in the UK.²⁵

The continuing media reports of alleged corporate tax avoidance, and the aftermath of the financial crisis and its impact on public finances, led to the calling by the G20 for further work²⁶ and the initiation of the Base Erosion and Profits Shifting (BEPS) project in 2013, carried out through the OECD, although with the involvement and growing prominence of non-OECD members including India and China²⁷. The ALP had been targeted by some of the most vocal critics of corporate tax avoidance as a facilitator of profit shifting by MNEs, so it was politically imperative that transfer pricing was one of the main areas of focus of BEPS²⁸. The final BEPS report in 2015 included significant transfer pricing measures included templates for transfer pricing documentation and country-by-country reports. However, it did not set out measures to address the lack of comparables, and complexity arising from the fact intensive nature of transfer pricing.

This charting of transfer pricing developments provides the context and backdrop against which the research interviews took place. Subsequently in 2017 the OECD released amended OECD Transfer Pricing Guidelines²⁹ consolidating the BEPS amendments. There was also a restatement of support for the ALP and a rejection of FA as

“the adoption of alternative bases for transfer pricing, like formulary apportionment, would require development of an international consensus on a number of key issues, which countries do not believe to be attainable in the short or medium term.”³⁰

In addition, the 2017 revised OECD Transfer Pricing Guidelines authorise tax authorities to recharacterize transactions and introduce more complex analysis requirements, for example in relation to risk and capital.³¹ New guidance on group synergies effectively changes the object of inquiry from what unrelated parties would charge, to what the particular related parties in question would charge.

²¹ (OECD, 2010 3 1.32). OECD, (1995). Transfer pricing guidelines for multinational enterprises and tax administrations 2017. Report of the OECD Committee on Fiscal Affairs, Paris: OECD Publishing (2017).

²² M.P. Devereux and J. Vella. (2014). “Are we heading towards a tax system fit for the 21st century?” (2014) *Fiscal Studies* 449.

²³ M.P. Devereux and J. Vella. (2017). “Implications of digitalization for international corporate tax reform” [2017] OUCBT WP17/07; O. Mazur “Transfer pricing challenges in the cloud” (2016) *Boston College Law Review* 643.

²⁴ See for example Y. Brauner, “BEPS: an interim evaluation” (2014) *World Tax Journal* 10; this highlights publicity for Apple, Microsoft and Google.

²⁵ See for example J. Thompson and V. Houlder “Starbucks faces boycott calls over tax affairs” (2012) *Financial Times* 17 October 2012 available at www.ft.com/content/5cd14dcc-187f-11e2-8705-00144feabdc0

²⁶ I. Young “BEPS and beyond,” (2018) *TAXline*, April 2018.

²⁷ Brauner above fn 24.

²⁸ R.S Collier and J.L. Andrus, *Transfer pricing and the arm's length principle*, (Oxford: Oxford University Press, 2017).

²⁹ Transfer pricing guidelines for multinational enterprises and tax administrations 2017. Report of the OECD Committee on Fiscal Affairs, Paris: OECD Publishing, 2017.

³⁰ <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm> (accessed on 7 October 2018). The 2017 United Nations Transfer Pricing Manual similarly endorses the ALP and largely follows the OECD BEPS project recommendations.

³¹ Collier & Andrus above fn 28 see this as particularly problematic stating that ‘if these issues are not addressed, this will accelerate the tax drivers to the cross-border mobility of capital, accelerate and expand the problems related to the taxation of digital businesses, and thereby present huge problems for the system of transfer pricing and the ALP, and for the existing international tax system as a whole.’²⁹⁵

³²While aiming to correct the information asymmetry between taxpayers and tax authorities, the complexity of the revised guidelines will create new challenges, and strain on resources, for tax administrations of all levels of sophistication, but particularly for developing countries. Many issues remain unresolved, for example the role of the ALP in evaluating capital structures.

Calls for formulary apportionment

An alternative way to determine the allocation of profits to each taxing jurisdiction is a formulary approach, not based on hypothetical prices for individual transactions, but on sharing profits between the different taxing jurisdictions according to a predetermined formula. In 2001, the European Commission proposed to abolish the existing separate accounting system within the EU and to introduce formulary apportionment: the Common Consolidated Corporate Tax Base (CCCTB). A three-factor formula was proposed, similar to the US state apportionment factors. This is one of a range of possible methods that could be used to determine the allocation of profits to taxing jurisdictions and, in this article, we use formulary apportionment as an umbrella term for an approach that applies a predetermined formula to the profits of a multinational group.

The profile of such an alternative approach is increasing, despite continuing pronouncements from the OECD supporting the ALP. There has been a growing criticism of the ALP from academic commentators and an increasing focus on formulary apportionment, with the discussion having evolved rapidly in recent years³³ giving rise to a substantial body of scholarship.³⁴ Much of the increasing focus on formulary apportionment stems from empirical evidence of distortions and income shifting under the ALP³⁵ leading to the charge of extreme inequity. The potential for income shifting under the ALP can give rise to scope for zero taxation, or “homeless income,”³⁶ a phenomenon that, it has been observed “does not provoke taxpayer complaints.”³⁷ Many commentators argue that formulary apportionment reduces the incentive and ability to locate taxable income in low tax countries thereby curbing tax base erosion and preventing tax avoidance: “the core reason for considering a formulary approach is prevention of tax avoidance”³⁸

³² J. Osborn and E.Khrpounova, “Advance Pricing Agreements in the Post-BEPS Era”, 2016 *Tax Notes* 150(19) 1179.

³³ M. Ylönen and T. Teivainen. “The Politics of Intra-firm Trade: Corporate price -planning and the double role of the arm’s length principle” (2017) *New Political Economy* 451.R.D.Bucks ”The case for worldwide unitary: stronger and better than ever” (2019) *Tax Notes*.

³⁴ See for example: Picciotto above fn 6; R.S. Avi-Yonah “The rise and fall of arm’s length: a study of the evolution of US international tax” (1995) *Virginia Tax Review* 90; F. Vincent, “Transfer pricing and attribution of income to permanent establishments: the case for systemic global profit splits (just don’t say formulary apportionment)” (2005) *Canadian Tax Journal* 409.; K. Clausing and R.S. Avi-Yonah “Reforming corporate taxation in a global economy; a proposal to adopt formulary apportionment” (2007) Discussion paper, the Hamilton Project The Brookings Institute; Mazur above fn 23; R.S. Avi-Yonah, K.A. Clausing and M. Durst, “Allocating business profits for tax purposes: a proposal to adopt formulary profit split” (2009), *Florida Tax Review*, 497;Devereux and Vella above fn 22.

³⁵ See for example: R De Mooji and S.Ederveen “Will corporate income taxation survive?” (2008) *De Economist* 227; H. Huizing and L.Laeven, L. “International Profit Shifting Within Multinationals: A Multi-Country Perspective” *Journal of Public Economics* 1164; K. Clausing “The US state experience under formulary apportionment: are there lessons for international taxation?” (2016) *National Tax Journal* 353. The OECD has recently published a Corporate Tax Statistics Database in response to concerns elicited during consideration of BEPS Action 11 about the difficulties in measuring profit shifting, available at <http://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm>.

³⁶ B. Wells and C. Lowell, “Tax base erosion and homeless income: collection at source is the linchpin” (2011) *Tax Law Review* 535.

³⁷ J. Fleming, R. Peroni and S. Shay. “Formulary Apportionment in the US International tax system: Putting Lipstick on a Pig” (2014) *Michigan Journal of International Law* 1.

³⁸ M. Durst “The tax policy outlook for developing countries: reflections on international formulary apportionment” (2015) ICTD working paper 32.

The dissatisfaction with the ALP, on the basis that it facilitates tax avoidance, links to the increasing concern about inequity with a particular focus on developing countries' eroded tax base.³⁹ Lower income countries are generally more dependent, relative to other countries, on revenues from corporate tax.⁴⁰ Furthermore, developing countries are disadvantaged because of a lack of public data on comparable enterprises⁴¹ and their domestic tax administrative controls and enforcement mechanisms may be under resourced in the face of aggressive transfer pricing challenges.⁴²

Proponents of formulary apportionment frequently cite instances where such an approach has operated for many years within a national context, including the US⁴³, Canada⁴⁴ and Germany.⁴⁵ Some of the conclusions drawn from the work appraising formulary apportionment at a national level lend support to the adoption of an international formulary apportionment approach,⁴⁶ although it also points to the scope for formulary apportionment to distort firm behaviour.⁴⁷ Formulary apportionment may lead to factor shifting, that is, manipulation of the elements of the formula, instead of profit shifting.⁴⁸ It is likely that new forms of avoidance would emerge⁴⁹, for example with respect to the sales factor which can be inflated through the inclusion of, for example, hedging transactions.⁵⁰ Furthermore, it is a significant challenge to obtain international consensus to a move to a formulary approach, and what formula to use is recognised. Any major change or transition to formulary apportionment is likely to be a long process⁵¹ with significant transaction costs⁵². There are also recurring accounting concerns about the measurement of the formula components, the profits that form the tax base⁵³ and the companies that constitute the group⁵⁴.

³⁹ See for example Durst fn 39 above; T. Hopper, P. Lassou and T. Soobaroyen, T. "Globalisation, Accounting and Developing Countries" (2017), *Critical Perspectives on Accounting* 125; O.J Otusanya "The role of multinational companies in tax evasion and tax avoidance: The case of Nigeria" (2011) *Critical Perspectives on Accounting* 316.

⁴⁰ E. Crivelli, R. De Mooji and M. "Base Erosion, Profit shifting and developing countries" (2015) IMF Working Paper WP/15/118, International Monetary Fund, OUCBT Working paper 15/09. Oxford University Centre for Business Taxation.

⁴¹ G. Cottani, "Formulary Apportionment: A Revamp in the Post-Base Erosion and Profit Shifting Era?" (2016) *Intertax* 755.

⁴² See for example C. Emmanuel "Exploring the transfer pricing conundrum" in T Hopper, M. Tsamenyi, S Uddin & D Wickramasingha (Eds) *Handbook of Accounting and Development*, (Cheltenham: Edward Elgar Publishing, 2012); Hopper, Lassou & Soobarayan, above fn 35; Collier and Andrus, above fn 28.

⁴³ K. Clausing, "Lessons for international tax reform from the US State experience under formulary apportionment" (2014) ICTD Research report 2.

⁴⁴ J. Mintz, J. and M. Smart, "Income shifting, investment and tax competition: theory and evidence from provincial taxation in Canada" (2004), *Journal of Public Economics* 1149.

⁴⁵ N. Riedel, "The downside of formula apportionment: evidence on factor demand distortions" (2009) *International Tax and Public Finance* 236.

⁴⁶ K. Clausing, above fn 44; Mintz and Smart above fn 45.

⁴⁷ Reidel above fn 46.

⁴⁸ L. Bettendorf, M.P. Devereux, A. van der Horst, A. Loretz, and R. A. De Mooji, "Corporate tax harmonization in the EU" (2014), *Economic Policy* 537; E. Eberhartinger, and M. Petutschnig, (2017). "CCCTB: the employment factor game" (2017) *European Journal of Law and Economics* 333; Fleming, Peroni & Shay above fn 38.

⁴⁹ Some proponents of formulary apportionment have also highlighted the need for anti-avoidance powers to counter those "gaming the apportionment formulas applicable" S Picciotto 2017 Unitary Alternatives and Formulary Apportionment in S. Picciotto ed *Taxing Multinational Enterprises as unitary firms* (Brighton: Institute of Development Studies, 32

⁵⁰ S-C. Chen "Tax avoidance in the sales factor: comparison between the CCCTB directive and USA's formulary apportionment taxation, *Indian Journal of Tax Law*, 3(2). See also J. Roin "Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Unitary Formulary Apportionment," University of Chicago Public Law and Legal Theory Working Paper No 170, 2007, that discusses scope for factor manipulation, cited by Collier and Andrus above fn 28 285.

⁵¹ Avi Yonah and Pouga Tinhaga, above fn 14.

⁵² Collier and Andrus, 2017 above fn 28.

⁵³ Durst, 2015 above fn 39.

⁵⁴ A. Ting "Multilateral formulary apportionment model – a reality check" (2010) *Australian Tax Forum* 95.

Most proponents of formulary apportionment do not present it as a panacea to the challenges of international taxation, rather an approach that diminishes, rather than fully resolves, the incentive and opportunity for income shifting, and also the challenges of transfer pricing administration. In terms of transfer pricing management and administration, there is little disagreement as to the nature of the respective advantages and disadvantages of the ALP and formulary apportionment; rather disagreement stems from the weighting given to each of these. For the ALP, there is a tension between the ability of a broad principle to adapt to different circumstances and the complexity and uncertainty this brings; conversely formulary apportionment involves a tension between a more straightforward system that is rigid and sometimes distortive in the sense that profit allocation is no longer necessarily tied to broader notions of economic activity.⁵⁵ The vagueness of the ALP means it can evolve to accommodate different circumstances and can cover very different transactions and situations. However, the disadvantage of such flexibility is the consequent lack of certainty as to whether transfer prices will be acceptable to the relevant tax authorities giving rise to uncertainty and the risk of double taxation. Uncertainty is largely due to the lack of comparables, and a clear standard for ascertaining and judging compliance, which is evidenced by “absurdly complex” documentation requirements⁵⁶. The fact intensive nature of transfer pricing management under the ALP can lead to, or exacerbate, disagreement between tax authorities, leading to unpredictable double taxation. There is potential for formulary apportionment to give rise to double taxation, when some countries adopt different formulas; but it has been countered that, under a fixed formulary approach, at least any double tax would be predictable.⁵⁷

Collectively, the extant research demonstrates increasing concerns with the ALP and increasing favour for formulary apportionment; to what extent is this echoed among those at work at the most senior level in transfer pricing?

Research methods

This study draws on data from two rounds of interviews, over a 10-year time frame⁵⁸. In 2006 17 research interviews were carried out, with interviewees drawn from those working at the most senior level on transfer pricing, with respect to the UK and the US, seeking to gain an insight into transfer pricing management in practice. These interviews generated extensive data on many themes in the context of transfer pricing, including findings in respect of UK-US APAs, previously published in the *British Tax Review*⁵⁹. Given the significant changes in the international tax and transfer pricing environment in the years after these interviews we sought to revisit the issues discussed, a decade later. Requests were made to those who were still working in international tax and transfer pricing for a further interview. Nearly half, 8, of the 2006 interviewees agreed to be interviewed again in 2016/17, providing an element of direct continuity to the study. The remaining second round interviewees were individuals identified as occupying the roles previously occupied by some of the

⁵⁵ Collier & Andrus above fn 28 refer in this regard to work by Dhammika Dharmapala *The Economics of Corporate and Business Tax Reform*, Oxford University Centre for Business Taxation Working Paper 16/04, 2016; this suggests that formulary apportionment will only address about half of the economic distortions arising from the existing regime and would potentially introduce new kinds of efficiency costs.

⁵⁶ Avi Yonah, Clausen & Durst above fn 35 at 6.

⁵⁷ Durst above fn 5.

⁵⁸ The first round of interviews was conducted in a six-month period starting in 2006 (the 2006 interviews) and in the case of the second round of interviews, (the 2016/17 interviews) most took place in 2016/17, with 3 conducted at the start of 2018; for convenience here, we use the phrase 2016/17 interviews to refer to this round. Both rounds of interviews were with interviewees working at the most senior level of transfer pricing in one of the following key organisations: tax authorities, tax advisers, corporate taxpayers and the OECD. Of the 34 interviews all but 5 interviews were conducted at the workplace of the interviewee (including London, Washington and Paris) and all but 3 of the interviews were face to face. The average length of each interview was approximately 65 minutes, and, with interviewees’ permission, interviews were recorded and transcribed.

⁵⁹ Rogers and Oats above fn 20.

2006 interviewees who had moved on. In both rounds, each interview began with an assurance of anonymity: interviewees were advised that quotations could be drawn on, but these would be unattributed. Some quotations are presented in this article to inform the discussion: these are anonymous, so quotes are denoted as “I-int” for a direct quote from a first-round interviewee, and “II-int” denotes a direct quote from a second round interviewee. The term arm’s length principle is preferred and used by interviewees from the UK and the OECD, while the term arm’s length standard, is preferred by those from the US. In the quotes presented in this article, the term ALP has been substituted for ALS, where necessary, both for reasons of consistency and for preserving anonymity. The analysis of the extensive interview data was supplemented by reviewing OECD Guidelines and publications, BEPS reports and practitioner publications.

Findings and discussion

In both 2006 and 2016/17, interviewees were asked for their views of the ALP and the potential alternative approach of formulary apportionment. In general, attitudes to each these approaches are linked: the merits and disadvantages of formulary apportionment largely link to the disadvantages and advantages of the ALP. Therefore, often the discussion of the advantages (and disadvantages) of a particular approach, can also form the basis of the discussion of potential disadvantages (and advantages) of the alternative approach.

2006 Attitudes to the ALP: flexibility and uncertainty

In the 2006 interviews, just over a decade after the publication of the OECD 1995 Guidelines, interviewees were generally supportive of the ALP, speaking positively about it. Advantages put forward included the principled way it took into account the economic conditions and the market, and its flexibility. The ALP was seen as a principled way of setting prices between related parties, reflecting economic reality by taking into account what unrelated parties would do in similar market conditions, in accordance with the OECD Guidelines. Flexibility was seen as an advantage, allowing the ALP to evolve over time to accommodate and respond to changes in the economy and the business environment: “the whole point is to reflect what’s happening in the marketplace, the marketplace is always changing, and so you can’t codify it” (I-int).

An interviewee described increasing acceptance of the ALP, envisaging that the application of it would go on to work in an improved way in the coming years:

“the arm’s length principle is really bedding down...I think the general understanding of it is improving so that you get far less sort of outliers, I think its maybe less political than it’s been” (I-int).

Thus, in 2006, just over a decade after the publication of the OECD Guidelines, this bedding down of the ALP indicated the potential for a deepening consensus on the ALP.

There was recognition that, under the flexibility of the ALP, the use of a profit split method was becoming increasingly commonplace, despite it not being based on arm’s length comparable prices and the OECD’s presentation of it as the method of last resort. While this was a move away from the use of comparable transactions, interviewees still considered it to be consistent with the ALP. The rise in highly integrated, complex MNEs poses difficulties, where it is difficult to identify comparables for gains (or losses) from integration and so profit split was again seen as appropriate and consistent with the flexible ALP.

In 2006, interviewees raised and discussed some problems of applying the ALP in practice, including problems with comparability and the consequent uncertainty as to whether prices would be deemed as compliant with the requirements of all countries.

2006 Attitudes to formulary apportionment: inflexibility and more certainty

The strong support for the ALP was matched by a dearth of appetite for formulary apportionment. Among many, there was a view that it was not worth even considering, as it would never happen: several interviewees dismissed it out of hand. In 2006, reasons put forward for opposition to

formulary apportionment included: its formulaic rather than principled approach that is not reflective of the market and economic circumstances of each individual taxpayer, and a lack of flexibility. Many interviewees in 2006 voiced reluctance to considering formulary apportionment as it was not seen as a principled approach reflective of an MNE's circumstances and so dismissing it, for example: "I think it is calculated to be wrong all the time" (I-int).

The flexibility of the ALP gives rise to a lack of certainty as to how it should be applied. In 2006, uncertainty arising from the imprecise principle was recognised by interviewees as a problem with the ALP, but one that was outweighed by the benefit of flexibility, and one that was anticipated would reduce as it bedded down. Thus, the uncertainty of the ALP was not seen as a difficult enough problem to merit consideration of a more certain formulary apportionment, which did not take into different circumstances: "because it's formulary it applies a one size fits all which can lead to quite distorted results" (I-int). Interviewees recognised that the vagueness of the ALP gave rise to problems, for both taxpayers and tax authorities but nevertheless maintained it was the best way to determine how profits should be shared out within a group of MNEs.

2006 Consensus

The consensus that emerged from the 2006 interview data on formulary apportionment was that there was not an appetite for a change to it. Rather, the consensus that had been built around the ALP was seen as an obstacle to any change. After the 1995 OECD guidelines different countries had introduced and administered new transfer pricing approaches which meant that obtaining a level of consensus for future change was seen as harder than before:

"what is different from 1995 is that most countries now have domestic legislation. Only the US had it in 1995. Other countries bring baggage with them. It's possibly harder to get consensus now because of domestic legislation" (I-int)

The details and formulas for a formulary method would require agreement and achieving that was not viewed as realistic:

"having tried to negotiate profit split APAs between countries, the chances of everyone agreeing on global formulary apportionment formula are sort of next to zero...this is cloud cuckoo land" (I-int).

On the possible shift to formulary apportionment, most interviewees could not envisage the first steps towards this being taken. Furthermore, the US had been a key driving force behind new rules and guidelines in the early 1990s⁶⁰ and so it was viewed as problematic for the US to be at the forefront of any possible move to formulary apportionment. An interviewee commented "the US can't take the lead. We've talked the entire world on arm's length now" (I-int).

2016/17 Attitudes to the ALP: flexibility, uncertainty and increased complexity

A decade later, an overlapping group of interviewees was again asked for their views on the ALP and formulary apportionment, an opportunity to gain views on the evolving ALP, with a longer period of experience of its operation in practice, just over 20 years after the issuing of the OECD 1995 Guidelines, and a year after the OECD published the final BEPS report. The 2016/17 interviews took place against a backdrop of significant change in the transfer pricing environment, something that was recognised by all interviewees.

In 2006 the ALP was seen as bedding down and becoming established, with a developing, deepening understanding of it. However, in the 2016/17 interview data, while there was still support for the ALP, it was more muted and more equivocal, with the initial responses evidencing less. There was recognition among all interviewees of the increased public concern following media reports of transfer pricing manipulation and tax avoidance by high profile MNEs. The ALP does not offer a set of rules to determine the right amount of tax with certainty. It was observed that the ALP is "about understanding business and coming up with what seems fair. That's quite hard for members of the public to understand" (II-int). This points to an acknowledgement of the significantly raised profile of transfer pricing and international tax as an issue of public attention over the preceding decade. Much

⁶⁰ Durst and Culbertson above fn 12 Eden, Dacin and Wan above fn 9.

of the complexity in transfer pricing arises largely from the flexibility of the ALP and increasing public scrutiny of corporate tax could be a driver for a move to a formulary approach, as that is more straightforward to explain.

In 2006 the ALP was described as having the strength of flexibility: this view of flexibility, as an advantage was not stressed in 2016/17. Rather, the ALP was described in terms such as being vague and open to different judgements, for example: “the arm’s length principle is this phrase that embraces a lot of stuff” (II-int). In 2016/17, the flexibility of the ALP that had previously been highlighted as a strength, was viewed as challenging, giving rise to complexity: taking all the different circumstances, functions and risk into account was elaborate and time consuming, requiring increasing levels of documentation and analysis work, and uncertainty persisted. Problems that had previously been identified in 2006 were reiterated, particularly the lack of certainty and comparables. There was increased concern about uncertainty causing the “tremendous growth” (II-int) in the number of disputes and MAP cases, voicing the challenges on the ground, reflected in the OECD MAP statistics. In 2006, the system for MAP had been referred to as “log jammed” (I-int) but the perception of interviewees in 2016/17 was that this had worsened further.

Interviewees also reported a further increased use of profit splits in practice and expressed the view that this was often the most appropriate and pragmatic transfer pricing approach. Thus, in the intervening years between 2006 and 2016, there has been a wider acceptance and use of profit split methods in practice and this could be seen as evidence of the flexibility of the ALP. Furthermore, BEPS was pointed to as a development that would result in more profit splits and so it was commented that “I think BEPS has made it easier, potentially, to have formulary apportionment down the line” (II-int).

2016/17 Attitudes to formulary apportionment: inflexibility, more certainty and reduced complexity

In 2016/17, interviewees expressed concerns with the problems of the ALP and a much less vociferous rejection of formulary apportionment compared with 2006. However, skepticism of formulary apportionment remained, stemming largely from issues of practicality, such as the factors to use and how to reach agreement. Some interviewees reiterated that formulary apportionment is not a principled approach; however, rather than rejecting formulary apportionment out of hand, there was a recognition that it was now on the agenda and there was a willingness to consider it:

“I think global formulary apportionment could work as long as it’s based on the real value and the activity, and then you come back to something which is quite difficult to define” (II-int).

In 2006/07, there was very little support for formulary apportionment, it was typically dismissed as an academic notion that did not merit serious consideration. Now, in 2016/17, there was a clear readiness to consider it, a recognition that the current system has problems, particularly with respect to dispute resolution, where the system is “clogged up” (II-int). It followed that formulary apportionment could not be automatically dismissed, and the option was now considered:

“I think it will not come so much from the fact that the arm’s length principle doesn’t work, it will come from the fact that government and tax administration just couldn’t figure out a way of making it work in controversy. You know, in a reasonable way” (II-int)

Much of the literature calling for formulary apportionment does so because under the ALP there is incentive for income shifting and zero taxation of some profits. Only one interviewee raised the issue of zero taxation, consistent with observations that taxpayers don’t complain about it⁶¹. However, there were recurring concerns about formulary apportionment on the grounds that it could give rise to double taxation, for example:

“It doesn’t result in a nice, clean apportionment. You end up with too much, bigger chunks, going to numerous jurisdictions and the amount being taxed is far more than 100%” (II-int).

⁶¹ Fleming, Peroni & Shay above fn 38.

This risk, for example when tax authorities apply inconsistent formulas, is acknowledged in the literature, tempered by some proponents of formulary apportionment with the proviso that such double taxation would not be uncertain.⁶²

2016/17 consensus

In the 2016/17 interviews the consensus for the ALP that emerged was a more uneasy one than had been anticipated in 2006, when the ALP had been seen as “bedding down” (I-int), with increasing frustration with the problems of consistent and predictable application in practice. The role of consensus remained important. In 2006 it was pointed out that there was a growing consensus built round the ALP. In 2016/17 it was pointed out that there were problems associated with the ALP, but the ALP was difficult to change due to the consensus that had built up around it. Accordingly, in 2016/17 the existence of the consensus was frequently given as a reason for continuing with the ALP; the long-standing consensus for the established ALP meant it was difficult move away from it.

A shift to an increased openness to the possibility of formulary apportionment in 2016/17 was also associated with an increased discussion of its practical challenges, which were discussed in much more detail than 2006. Concerns were raised about the selection and use of specific formulas, highlighting the recurrent tension between flexibility (giving rise to complexity) and simplicity, (arising from inflexibility). Also, the potential for tax avoidance under formulary apportionment, for example by factor-shifting, was raised by all interviewees. The potential for factor shifting had been mentioned in 2006 but in less detail, largely because many had dismissed formulary apportionment as not meriting discussion.

2016/17 Formulary approaches in practice

Interviewees gave examples of where an apportionment approach was followed in practice, in particular increased use of a profit split approach. An interviewee linked the increased use of profit splits to formulary apportionment:

“more widespread use of profit splits would inevitably lead to formulary apportionment. All formulary appointment is, is an administrative and simplified version of profit split” (II-int).

Furthermore, over time, precedents and accepted practice have settled on approaches, that are formulary in nature, in line with views that paying attention to using apportionment for individual remedies, rather than in a standard way is a sensible way forward⁶³ Gradually, over time aspects of a profit split approach, such as a certain percentage, become accepted as appropriate. As there is an increasing body of experience of what tax authorities deem to be acceptable, such informal precedents are increasingly followed and so reinforced, rather than following a principled approach that reflects specific circumstances and market reality. For example, one interviewee explained:

“I think we’ve already been telling clients you’ve got to be consistent, but now you’re almost forcing consistency where they’re not consistent because it’s too dangerous to have different margins and stuff even when the facts are different. So, you sort of end up perhaps with a bit of formulary apportionment, or a safe harbor think, ‘Right, ok, we’re just going to put all our distributors on three per cent, or whatever, regardless.’ So people are thinking of ways of how they deal with that. So, it’s probably getting to more consistency and more simplicity” (II-int).

This illustrates that sometimes transfer pricing management is not always undertaken on a case-by-case basis, with consideration of all the specific facts, but rather with reference to precedents of what has previously been treated as acceptable, to minimize the risk of scrutiny and investigation from the tax authorities. Other interviewees referred to this, for example another interviewee commented:

“basically, we already have some form of formulary apportionment. These methodologies say, ‘Distributors get three per cent.’ There you go, there’s a formula. So basically, we are backing into this” (II-int).

⁶² Durst, 2015 above fn 39.

⁶³ S. C. Morse, “Revisiting global formulary apportionment” (2010) *Virginia Tax Review* 593.

A further example offered of a formulary approach being adopted related to the intellectual property in an integrated MNE, the patent box rules in the UK. This is “a very straightforward, simple cost apportionment, where you don’t actually look at value that’s been embedded” (II-int), rather than an approach based on the development costs incurred in each jurisdiction.

Therefore, despite recent transfer pricing rules and OECD pronouncements reiterating the ALP, there is an increasing number of situations where, when determining transfer prices, a formulary approach is used, either through the requirements of the law, or because an approach has become accepted over time. This can be seen as evidence of the flexibility of the evolving ALP, however such instances could also be seen as not fully consistent with the overarching, principled approach of the ALP, that takes into account different circumstances and the market and economic conditions. Each of these different instances of acceptance of a formulary approach could be seen as possible step towards a wider adoption of formulary apportionment and an indirect way to build some consensus on formulary apportionment more broadly.

Conclusion

This article contributes new insights based on empirical data to the on-going debate about the workability of the ALP, and the potential alternative approach of formulary apportionment, by exploring the views and perspectives of senior transfer pricing professionals. Our interviewees were drawn from the most senior professionals working in the UK and US tax settings and the significant overlap of interviewees in 2006 and 2016/17 offers evidence of shifting attitudes towards the ALP and formulary apportionment, as the transfer pricing environment evolves. This information was garnered from a hard-to-reach group, providing new insights into changing attitudes towards the acceptability of different transfer pricing approaches.

Over the timeframe of the study, the related academic literature reflects a rising disillusionment with the ALP, rooted in concerns about tax avoidance, and a move along the continuum towards formulary apportionment, notwithstanding the acknowledgement of some disadvantages of this approach. A shift in this direction is echoed in the practitioner interview data, albeit starting from a different position on this continuum. In the main, the data evidence a consensus that, in 2016/17, the ALP is seen as increasingly problematic, and there is now a willingness to consider formulary apportionment, perhaps facilitating future changes in attitude and practice. However, this is driven less by concerns about inequitable income shifting, and more by frustration with the complexity and problems of the workability of the ALP in practice.

Consensus and the need for agreement is a recurring theme both in the literature and the interview data. In 2006, the ALP was presented as a principled, flexible approach, and consensus had built around it. In 2016/17, despite recurring problems with the ALP, and the principled approach not working as well as had been anticipated, the consensus was now seen as a reason to retain it, rather than making a major change that would “squander that valuable consensus”⁶⁴. Accordingly, the consensus that was previously built up for the ALP, is now used as a reason to keep the ALP, even though the ALP is not now fully operating in the way that was envisaged when the consensus was being built up. This longstanding, sometimes uneasy consensus for a vague principle can be seen as an important, enduring counter argument to the lack of consensus on formulary apportionment both as a general approach, and more specifically regarding the specific formula to be used.

In the years covered by this study, there have been increasing calls for formulary apportionment by academic commentators. However, despite this discussion and increase in the academic literature on formulary apportionment, it is observed that a shift towards formulary apportionment would require “a wrench to the mindset of many international tax professionals.”⁶⁵ This longitudinal study of

⁶⁴ Kane above fn 18.

⁶⁵ S. Picciotto “Introduction” in S. Picciotto (ed) *Taxing Multinational Enterprises as Unitary Firms*, (Brighton: Institute of Development Studies, 2017) 2.

international tax professionals shows that, while a wrench has not taken place, there is evidence to indicate incremental steps towards a change in the mindset, to view formulary apportionment more positively and to make more use of formulary approaches in practice. While showing an increasing openness to consider formulary apportionment, the interview data also identified senior practitioners' areas of concern with the ALP and formulary apportionment. This offers particular areas for attention, where proponents of formulary apportionment could focus, in order to acknowledge and address those concerns, and press their argument for formulary apportionment. Only time will tell whether these arguments will prevail.